UNITED
NATIONS

TD

United Nations
Conference
on Trade and
Development

Distr.
GENERAL

TD/B/47/6
2 October 2000

Original: ENGLISH

TRADE AND DEVELOPMENT BOARD
Forty-seventh session
Geneva, 9 October 2000
Item 2 of the provisional agenda

SEGMENT FOR HIGH-LEVEL PARTICIPATION :

REGIONAL INTEGRATION AND THE GLOBAL ECONOMY

Issues note by the UNCTAD secretariat

GE. *200005242O* LS

ENG

I. INTRODUCTION

1. The increased interest in regional economic integration has intensified concerns and debates about its impact on alleviating poverty and enhancing the prospects for development. These concerns also reflect the fact that record rates of growth in international trade in goods and services and direct and portfolio capital flows have not substantially improved the development prospects of many developing countries. For example, an estimate based on current trends shows that by 2008 the number of people living on less than a dollar a day will remain stable at about 1.2 billion.

2. International economic integration is a complex process involving trade in goods and services, foreign direct investment and monetary issues. If properly managed, and complemented with appropriate policies, international economic integration could make a significant contribution to enhancing the position of developing countries in the world. This note identifies some of the economic aspects of regional economic integration in relation to its potential role in promoting pro-poor development.

II. WHY REGIONALISM?

3. Developing countries have consistently and openly acknowledged that increased international trade in goods and services, capital flows and foreign direct investment within a framework of a fair and equitable set of multilateral rules are integral components of the development process. However, existing approaches at the multilateral level have fallen considerably short of meeting the needs of developing countries. The concerted efforts of developing countries to become full participants in an increasingly interdependent global economy continue to be stymied by biases and asymmetries in both the trading and financial system. The bottom line for most countries is that they are not able to approach and sustain the kind of growth performance required to begin tackling the problems of poverty and underdevelopment. The question that is central to this debate is: does regionalism offer a solution?

4. On the trade side, one of the major areas of disappointment lies in both the architecture and lack of benefits arising from the Uruguay Round agreements. These problems are so entrenched that the implementation of the Uruguay Round agreements is a key issue in the debate on how the multilateral trading system could better accommodate the interests of developing countries.

5. Apart from the difficulties encountered in international trade, the increased frequency of international currency and financial market crises, including in countries with a record of good governance and macroeconomic discipline, suggests that financial instability is systemic in nature and global in reach. Moreover, though financial flows have been at the centre of recent crises in developing countries, trade

imbalances and other external shocks have undoubtedly added to the difficulties of managing more open capital accounts.

6. A main reason for the growing vulnerability of developing countries to external shocks has been the dismantling of institutional checks and balances at the national level and particularly the failure to redefine appropriate government interventions and controls as economies became more integrated into the global economy. Given that a wholesale retreat from greater openness is neither likely nor desirable, national policy efforts are not sufficient to deal with future financial crises. There is therefore a need to establish institutions and mechanisms at the global level in order to reduce the likelihood of such crises and to manage them better when they occur.

7. However, the slow pace, the modest goals and the absence of decisive action in respect of multilateral reforms of the international financial system create incentives for Governments to work towards regional arrangements to protect themselves from future speculative attacks and financial crises.

8. Thus, failures at the multilateral level to solve issues that require international cooperation are one reason for identifying regional policy responses that better account for the needs of developing countries. These arrangements could also provide a framework that supports and accommodates existing trade, investment and capital linkages.

9. Another reason for regionalism is the opportunity that it offers to stage the integration of developing countries into global markets. Market access for goods is at the core of trade programmes of most regional integration efforts. A major development issue in this regard is the ability of small member economies to access the markets of bigger member economies and where possible exploit scale and scope economies. On the import side, a sequencing of gradual market opening allows firms, especially small and medium-size enterprises, the time needed to learn how to compete. This stems from the fact that regional integration arrangements can have members at different levels of development, but such divergence is unlikely to be as great as with full liberalization. There is some evidence that regional integration tends to be effective in stimulating trade and industrial change where the members have a strong link to a major economy/market. Such examples include SACU with South Africa, MERCOSUR with Brazil, and NAFTA with the United States.

10. It should, however, be pointed out that regional integration arrangements are likely to arise from a combination of factors that go beyond economic reasons. These could include geopolitical objectives, such as strengthening political relations or security with neighbouring countries. Whether economies benefit from a particular regional trade agreement depends on the nature of the enforcement mechanism, the scope and coverage of its provisions, and the broader circumstances in which the agreement operates.

III. APPROACHES TO REGIONAL INTEGRATION

11. Although the need for cooperation and coordination at the regional level has long been acknowledged, there is no single unified approach that fits all regions and different types of countries. Attempts at balancing the positive and negative aspects of regional integration arrangements (RIAs) have resulted in a variety of approaches to regional economic integration. A common approach has been to conclude arrangements such as customs unions and free trade areas. In some particular cases, a secretariat subsequently administers these agreements. In other cases, informal approaches without secretariats that emphasize voluntarism, trade and investment facilitation and cooperation have been adopted. Recently, a different approach that liberalizes trade and investment over segments of national borders has also become common.

12. Regional agreements among developing countries have been an important feature of those countries' economic policies over the last 30 years. The rationale for these initiatives was similar to that for other arrangements: to promote industrialization and benefit from economies of scale at the regional level. However, despite an initial expansionary period, many of these arrangements failed to implement the agreed provisions. The time lags in implementation and the partial failure of these attempts to manage trade in support of strategic industrial policies led many developing countries in the 1980s to shift their approach towards regional trading schemes. In the new international economic environment characterized by rapid globalization and increased liberalization of trade flows, RIAs among developing countries have been redesigned to become more outward-oriented in order to remain central to the development strategy of developing countries.

13. The first wave of regional integration efforts was characterized by inward-oriented integration amongst similar countries that focused predominantly on tariff and non-tariff measures. Recently, however, the trend is moving towards outward-oriented, mixed agreements where developed countries are signing RIAs with developing countries. Perhaps the most significant development in RIAs is their trend towards 'deep integration' issues that go beyond border measures. Increasingly, they now include measures on investment, competition policy and services. This expansion into non-border measures has also encompassed, in some cases, areas of domestic law such as standards.

14. Three specific efforts to broaden RIAs can be identified – in services, investment and competition policy. Some RIAs included services provisions prior to the completion of the General Agreement on Trade in Services, and hence provided some experience in liberalizing this mode of international commerce. Developing country RIAs also include services provisions. For example, the ASEAN Free Trade Agreement includes a services protocol, and MERCOSUR and SADC have services provisions.

15. There is still considerable debate about responding to the question of whether or not formal RIAs can actually have an effect on trade flows. Part of the problem is in identifying the counterfactual – what would have been the pattern of international trade flows in the absence of an RIA? Various attempts at disentangling effects have concluded that for some agreements the share of intra-bloc trade did not rise as an independent result of an RIA. Part of the explanation lies in the myriad of factors that affect trade, in particular growth in incomes. For many of the countries that are members of RIAs, trade with non-member countries increased, which dampens the effects of trade diversion.

16. Not only trade-related but also investment provisions are now becoming quite common in many RIAs, due mostly to the interdependence between the two mechanisms for integration. There is evidence that FDI responds to regimes that are open to trade and that have undertaken significant market reforms. Hence, RIAs with only a trade component can add a degree of investment policy credibility, which can be further enhanced by including investment provisions.

17. RIAs can also affect FDI flows through their impact on market size and growth, which are two of the more important economic determinants of FDI. The possibility of accessing a market wider than that of a single country for tradable goods and services becomes an inducement to invest in the region. This incentive is further enhanced if the RIA is a customs union, since 'tariff jumping' FDI could be induced.

18. RIAs can also affect investment flows in the absence of specific investment provisions through rules of origin provisions that are an important element of any RIA. A very high rules of origin threshold induces investment within the geographic area of the RIA in similar fashion to that of local content schemes. In order to obtain the preferential market access associated with an RIA, production will have to meet the rules of origin criteria. In some cases this may have a distorting effect on resource allocation.

19. Efforts to include investment provisions are the most notable developments in the area of deep integration. Chapter eleven of the North American Free Trade Agreement is perhaps the most prominent due to its scope, coverage and dispute settlement mechanism. The nine members of the ASEAN Free Trade Agreement have agreed to establish an ASEAN Investment Area. The agreement is notable for its negative list approach and structured phase-out of restrictions in the temporary exclusion list.

20. Despite the scope for enhancing development prospects through coordination or harmonization of various economic policies at a regional level, only a few RIAs have managed to address sensitive sectors and issues. In most cases these sectors are excluded or protected through overarching contingent measures. So far only a handful of RIAs have seriously tackled issues such as streamlining competition and

antidumping policies. For example, only the European Union, European Economic Area and Australia-New Zealand Closer Economic Relations Trade Agreement have agreed to replace antidumping measures with competition policies. A slightly different approach was adopted in the Canada-Chile FTA, where antidumping was simply abolished, instead of using competition policy as an alternative tool for free and fair trade at the regional level.

21. Deepening and strengthening regional integration through trade and FDI flows raises a question as to whether or not these efforts need to be complemented with parallel efforts on monetary flows. Awareness of the need to investigate possible avenues for regional financial integration rose during the recent financial crises.

22. There is extensive experience in regional monetary arrangements, dating back to the last century. The European Union provides the most significant contemporary example but there are several other arrangements involving developing countries designed to facilitate mutual international payments and to provide mutual support in external financing. Although some view such arrangements as conflicting with the pursuit of multilateral reforms, others see their design as an essential complement to the process of creating a more integrated and balanced global economic system.

IV. ISSUES ON PURSUING A DEVELOPMENT-FRIENDLY REGIONAL INTEGRATION STRATEGY

23. Empirical evidence about the extent to which RIAs enhance the prospects for economic growth is mixed, depending on the features of the arrangements. The recent experience with 'new regionalism' suggests the potential for accelerated growth still exists, making it incumbent on national policy makers and international organizations to design appropriate regional integration schemes. What must be done is to develop a coherent and pragmatic strategy that allows developing countries to use regional economic integration as a mechanism to meet the demands of global competition, while at the same time improving the quality of their international economic integration. In this regard there are a number of issues at different levels that need to be addressed so that developing and developed countries can construct RIAs that are pro-poor and development-friendly. These issues will inevitably take into account the linkages between trade in goods and services, foreign direct investment and monetary issues.

A. Regionalism and multilateralism

24. Regionalism and multilateralism should be not be perceived as substitutes. Both have existed for a substantial period of time, and efforts to intensify regional linkages will continue, despite progress at the multilateral level. The central issue, therefore, is to identify ways to ensure that the dialogue between regionalism and multilateralism from the development perspective is intensified.

25. This would include ensuring policy coherence between efforts at both levels, especially where the degree of discrimination in favour of members of a grouping is significantly large. Policy coherence between the two sets of regimes could be envisaged to ensure that vital national interests in terms of development and poverty alleviation are advanced in both regimes.

26. It is entirely possible for negotiations within RIAs to be WTO plus in the sense that they could be precedent-setting in including issues that are not yet part of current WTO negotiations. At the same time, regional integration can deal with the same issues dealt with under the WTO, while involving separate packages. For example, market access negotiations in the WTO aim at MFN (non-discriminatory treatment), whereas a regional integration grouping with a free trade agreement involves a discriminatory arrangement. How far should developing countries progress beyond WTO disciplines? To what extent should deep integration be encouraged within RIAs, and how will this affect the prospects for development? What disciplines are required at the multilateral level to ensure policy coherence?

27. The growing trend in mixed agreements also raises issues of how the developing countries should approach regional negotiations. In particular, special and differential treatment in the form of exemptions and longer transition periods for meeting obligations are allowed for developing countries in mixed RIAs. In some cases, special funds and programmes are also established to assist developing countries to meet their obligations, handle adjustment costs and implement the agreed provisions. However, given the general level of dissatisfaction over the value of special and differential treatment at the multilateral level, are there lessons at the regional level for designing more effective special and differential treatment measures?

28. The record of achievement for South-South arrangements remains mixed. Some have been successful in encouraging both economic growth and development, while others have not. What efforts are required to assist in designing South-South arrangements that encourage enterprise development, promote competitiveness and allow these countries to better meet their development needs? There is an urgent need to identify more efficient mechanisms to augment the negotiating capacities of developing countries, especially within the context of South-South agreements. How can this be accomplished? What role is there for international institutions?

B. Investment and enterprise development in regional agreements

29. There are those who argue that plurilateral rules are needed in a world where FDI flows are growing at a record pace. Others argue that these flows have increased in the absence of investment rules. Nevertheless, there is a growing and visible tendency to negotiate investment provisions at the regional level, creating the expectation that such efforts are assisting firms, especially small and medium-sized enterprises, to develop the capacity to compete in international markets.

30. The approaches to handling investment issues have varied considerably. The North American Free Trade Agreement has a broad-ranging provision that includes firm-state dispute resolution, whereas some RIAs exclude investment completely. Others such as APEC have taken an incremental approach by endorsing a set of non-binding investment principles. Within the context of enhancing development prospects, are there clear advantages of one approach over another? Should investment arrangements be separate from trade arrangements?

31. Regardless of the approach that has been taken, a major issue is whether or not the expansion of RIAs to include investment will influence investment decisions. Enhancing the environment for investment need not be confined to addressing legally binding rules. It could also include concerted attempts at investment facilitation. In this regard, what policy measures have regional groupings adopted to make their region "attractive" to investors within the region and to "overseas" investors? What has been the medium-to-long-term effects on enterprise development within member States? Are there specific measures that can be targeted at small and medium-size enterprises to allow them to develop competitive advantages from RIAs that will allow them to compete in global markets?

C. Regional monetary arrangements

32. Given the links between trade and finance, existing RIAs may well serve as an appropriate platform to address a number of concerns identified in the wider debate on reform of the international financial architecture. Better information gathering, standard setting and surveillance of national policies have all been stressed in the wake of the Asian financial crisis. However, could greater familiarity with and sensitivity to local conditions that would complement any global efforts be expected from regional institutions?

33. Furthermore, regional monetary arrangements may have the capability to pool significant national reserves and act as an effective crisis lender when the global modalities regarding the provision of liquidity, its adequacy, the conditions attached to lending and its funding still contain large gaps and many of their features are controversial. Is such an approach feasible?

34. Timely provision of international liquidity to pre-empt large currency swings is seen as essential to effective crisis management and prevention, and there is a growing consensus that better management of exchange rates in developing countries requires targeting real exchange rates. This again might best be undertaken at the regional level, particularly where close regional trading ties are an integral part of growth dynamics.

35. In all these respects, the strength of regional institutional arrangements, their phasing and the scope of membership require careful examination. However, since even the most successful experiences with regional integration of trade, production and financial flows have produced both positive and negative influences on financial stability and growth, the prospects for success of new arrangements in this area will be enhanced by a careful examination of existing ones and of how their best features may be adapted to other regions.

36. Furthermore, a number of general issues regarding the compatibility of regional and monetary arrangements need also to be addressed. For example, is there more to cooperation than standard setting, improving transparency, monitoring and sharing information? What would a regional monetary fund look like and how would it work? What are the possibilities for cooperation and coordination at the regional level on exchange rate policies? Are regional arrangements an obstacle to further global integration? How would trade and financial regional arrangements be coordinated? What coherence problems would policy makers face?